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Risk and Uncertainty in Financial Reporting and the Auditor's Role

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Grant's Is Going Out of Business

Just as the newspaper, radio and TV ads say, this is an honest-to-goodness closeout sale. W. T. Grant Company, one of the nation's major retailers, has filed for bankruptcy.

Predictably—and it's one of the few accurate predictions possible when a company declares bankruptcy—everyone involved in the issuance of the financial statements, including the independent auditors, has been named in a class action suit alleging past financial statements were false and misleading. Such events raise a critical question: What is the auditor's obligation to warn investors of impending trouble?

A Look at the 1974 Annual Report

The untutored eye of the ordinary investor only had to be open to see W. T. Grant was in trouble. In his opening message to stockholders, James G. Kendrick, Chairman of the Board and President, outlined "... the three most serious problems facing the Company:

- A serious merchandise imbalance.
- The severe burden posed by the accelerated store expansion program.
- The excessive build-up of credit receivables, financed at high interest rates and administered through an exceedingly expensive credit program."

For the year ended January 30, 1975, sales dropped slightly, but \$24 million was charged for store closing expense, net credit expense went from approximately \$6 million to \$161 million, and earnings showed a loss of nearly \$177 million, after having declined to \$11 million for the year before. Short-term debt had increased steadily over the last five years to \$600 million. The current ratio dropped from a range of 1.5 to 1.7 in past years to 1.2. Dividends per share of common stock were cut from \$1.50 in prior years to 30¢.

All that information was spelled out in detail for investors. Anyone who continued through the annual report to the notes to financial statements found more

* This paper presents the author's personal views and is not necessarily representative of the views of any AICPA Committee, the Commission on Auditors' Responsibilities, or other AICPA or Commission staff members.

distressing news. Changes in the company's borrowing agreements revealed creditors and suppliers of merchandise were very concerned with Grant's ability to pay.

The Auditors Were Uncertain

Grant's independent auditors issued the following "subject to" qualified opinion dated April 18, 1975.

We have examined the consolidated statements of financial position of W. T. Grant Company and consolidated subsidiaries as of January 30, 1975, and January 31, 1974, and the related consolidated statements of operations, capital and changes in financial position for the 52 weeks ended January 30, 1975 and the year ended January 31, 1974. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The financial statements of Zeller's Limited, used as the basis for recording the Company's equity in net earnings of that corporation, were examined by other independent accountants whose reports were furnished to us. Our opinion expressed herein, insofar as it relates to the amounts of net earnings included for Zeller's Limited, is based solely on the reports of the other independent accountants.

As discussed in Note 10 to the financial statements, the Company has protested certain deficiencies in consolidated Federal income taxes proposed by the Internal Revenue Service for the years ended January 31, 1964 through 1971, and is presently in litigation regarding such proposed deficiencies for the years ended January 31, 1964 and 1965. It is not practicable to estimate the additional income taxes and interest payable, if any, at this time. As discussed in Note 2 to financial statements, the continuing value of the Company's total investment in the common stock and convertible notes of Granjewel Jewelers & Distributors, Inc., a 51% owned subsidiary, may be impaired as a result of the potential inability of such subsidiary to continue as a going concern.

In our opinion, based on our examinations and the reports of other independent accountants, subject to the effects, if any, on the financial statements of the ultimate resolution of the matters discussed in the preceding paragraph, the financial statements referred to above present fairly the consolidated financial position of W. T. Grant Company and consolidated subsidiaries at January 30, 1975 and January 31, 1974, and the consolidated results of their operations and the changes in their financial position for the 52 weeks ended January 30, 1975 and the year ended January 31, 1974, in conformity with generally accepted accounting principles applied on a consistent basis after restatement for the change, with which we concur, in the method of accounting for finance income as described in Note 1 to the financial statements.

What Is the Purpose of the "Subject to" Qualification?

Is the auditor pointing to something that is wrong with the financial statements? The answer has to be "no" because then the report would indicate a

departure from generally accepted accounting principles and the qualification would be introduced by "except for."

Is the auditor only emphasizing a matter that is already apparent from or disclosed in the financial statements? Note 2 discloses that "... because of the net loss incurred by Granjewel and difficulties in obtaining adequate financing sufficient for continued business operations and compliance with terms of loan agreements, it is not presently determinable as to whether such subsidiary will be able to continue as a going concern." The dispute with the IRS is also fully explained in a note.

Should the "subject to" qualification be viewed as a withholding of an opinion on a portion of the financial statements that is indeterminable because of the uncertainty? Does the qualification, therefore, indicate a possible future adjustment of that portion of the statements?

Perhaps the function of the "subject to" qualification is only to post a warning of impending trouble. If that is its purpose, how serious or imminent should the matter be before qualification is required? Should investors have expected the auditor's report to point to the information in the annual report that showed W. T. Grant Company might not continue in existence? Certainly that possibility should have been apparent to the investor from a quick reading of the annual report. But why then is any qualification necessary?

The auditor's reporting obligation for significant or unusual uncertainties is far from settled. The answer ultimately depends on the view taken of the independent auditor's role. The auditor's role is to add credibility to financial information. The auditor cannot change the risk of doing business. Neither is it possible to guarantee the success of the businesses that are audited. One important facet of the free enterprise system is that every business has the opportunity to fail.

Information Risk vs. Business Risk

Two distinct types of risk accompany investment in securities.¹ Information risk is the risk associated with production and distribution of financial information. It represents the possibility that the same business conditions will appear to be different because of errors in the process of accumulating, summarizing, or presenting information. Reducing information risk is the auditor's job.

Business risk represents the forces in an uncertain economy. Success in business requires taking chances. Big success requires huge gambles. Investors who want to share in the possibility of success assume the risk that naturally accompanies the uncertainties inherent in business activities.

How Do Uncertainties Affect the Auditor's Concern with Information Risk?

The auditor's responsibilities for reporting on financial statements are covered in the AICPA's Statements on Auditing Standards. Statement on Auditing Standards No. 2 advises independent auditors that "... when there are material uncertainties the outcome of which is not susceptible of reasonable estimation, the auditor should consider whether to express an unqualified opinion or to qualify his opinion. . ." An opinion qualified because of an uncertainty takes the general form of the auditor's report on W. T. Grant's financial statements. The form of

an auditor's qualified opinion is spelled out in detail, but the meaning and significance of a "subject to" qualification and what should require it are still debated by accountants.

For example, Henry Hill recently expressed the view that "the proper method of reporting on uncertainties seems to be the greatest uncertainty of all."² Louis H. Rappaport has described the major point of contention in these words:

Some accountants contend that the "subject to" qualification . . . is redundant and unnecessary. In most cases where it is used, there is a clear reference to information in the statements, indicating that the matter cannot be resolved. A lawsuit, for example, is awaiting judicial determination, and counsel is unable or unwilling to forecast the result. An important tax case is awaiting decision in the Tax Court. A company's claim for reasonable profits on government contracts is before the Renegotiation Board. A company's basic patents are being challenged by competitors. A company's application for rate increases is being heard by a regulatory commission having jurisdiction over rates. Where these or similar circumstances exist, in all likelihood they are set forth in the financial statements or in notes to the statements. Since the statements with their notes do set forth the company's financial position and results of operations, what good purpose is served by the "subject to" language in the accountants' certificate calling attention to what is in the statements? These accountants contend that qualifications and exceptions should be restricted to those matters with respect to which there is a disagreement between the accountant and his client. In the circumstances which we have been discussing there is no dispute; the accountant presumably is completely in agreement with the representations in the statements.

Other accountants, however, contend that in these circumstances the company's financial position and/or results of operations are indeterminate and they are therefore not in a position to form an opinion in respect of the matter in question. For that reason, and for reasons of emphasis, they believe the "subject to" qualification is appropriate.³

The debate on "subject to" qualifications has been going on for some time. Some accountants have the impression that proper use of "subject to" qualifications was settled long ago. Actually, an accounting series release by the SEC as recently as 1962 set the present ground rules and caused the "subject to" qualification to assume its current significance. Independent auditors had recognized the possible need to qualify opinions in the early 1900's and the "subject to" phrase was one of the earliest used. However, as late as the 1950's the phrases "subject to" and "except for" were used interchangeably.

In Accounting Series Release No. 90, the SEC specified the following distinction:

A "subject to" or "except for" opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The "subject to" qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date.

Shortly after ASR No. 90 was issued, one accountant observed:

It has been our opinion for many years, dating back to pre-SEC days, that the words "subject to" in an opinion paragraph were so ambiguous that they conveyed no clear-cut meaning to the reader. There is no way of telling whether they are intended to be a qualification of the opinion, or whether they are intended merely to direct the attention of the reader to some significant fact which has been more fully disclosed elsewhere.⁴

A newcomer to the financial reporting scene might reasonably wonder what all of the fuss is about. What difference does it make if auditors' opinions are qualified and, if they are qualified, why does use of "subject to" rather than "except for" make any difference?

The Importance of Being Uncertain

For one, the SEC is very concerned with the form and content of the auditor's report. Under the administrative procedures followed by the SEC staff, the type of auditor's report has important consequences. Generally, financial statements will not be acceptable in a filing if the auditor is unable to express an unqualified opinion because of a departure from generally accepted accounting principles or a limitation on the scope of the examination. On the other hand, a qualification caused by an uncertainty is not automatically unacceptable.

In practice, the "subject to" qualification has become an administrative convenience. Since it is relatively easy to recognize that a qualification is introduced by "subject to" rather than "except for," the "subject to" phrase has become the password for an acceptable qualified opinion. Thus, one of the problems caused by the "subject to" qualification is that since it is acceptable to the SEC, any matter that can possibly be regarded as an uncertainty may receive a "subject to" rather than an "except for" qualified opinion.

A "subject to" qualified opinion, however, may not be so acceptable to investors. In its 1972 annual report, Boothe Computer showed a \$36.5 million write-off of additional depreciation on its portfolio of IBM 360 equipment. Commenting on Boothe's annual report, *Forbes* magazine described a "subject to" qualification in this exuberant language:

Now we read that even with the decks thus cleared, Boothe's auditing firm, Touche Ross & Co., had still qualified its opinion of the company's 1972 statements. A qualified opinion is no laughing matter. It's like tacking a quarantine notice up on a company's door. Bankers, creditors, beware! Bondholders, stockholders, on your guard! Touche Ross was saying that even with the carrying value of Boothe's rental equipment pared way, way down by the write-off, it still had serious reservations about the company's ability to recover the remainder of its computer investment through future rentals.⁵

Thus, a "subject to" qualified opinion has several consequences. In comparison to other types of qualifications, the company's financial statements are acceptable to the SEC, but investors are warned reported results may at some future date be adjusted. Also, the general belief has been that by pointing out the uncertainty the auditor will be absolved of responsibility if the uncertainty is resolved unfavorably.

The influence of a “subject to” qualification makes resolution of questions concerning its meaning or its necessity important. What are the relationships among the auditor’s opinion, the uncertainty, and the financial statements? Is the opinion or the financial statements “subject to” the uncertain outcome? What purpose is the “subject to” qualified opinion intended to serve and does it do so effectively?

Forbes’ consideration of Boothe’s 1972 annual report, for example, points out that two other computer leasing clients of the same public accounting firm received clean opinions that year. Both Leasco Corporation’s leasing subsidiary and Greyhound’s subsidiary, Greyhound Computer Corporation, are in the same business as Boothe. All three companies had similar-sized rental portfolios in the \$200 million plus range and all were facing the same competitive problem of IBM’s new 370 computer line. *Forbes* expressed the following conclusion on the merits of “subject to” qualifications:

As for us, we could only conclude that Touche Ross would have done us all a greater service if it had explained in more specific detail exactly what it was that it was certifying—that all three companies face significant uncertainties, but that in its opinion Boothe’s uncertainties are more significant. Shareholders would not assume, as they may have by the absence of write-offs and dirty opinions, that Leasco and Greyhound are home free in computer leasing.⁶

In other words, investors may believe the absence of a “subject to” qualification means a company’s financial statements are not affected by significant uncertainties, but business risk is unavoidable.

A Horse Is a Horse—Of Course

A simple analogy may put the question concerning the auditor’s responsibility for reporting on uncertainties in perspective. When he was later questioned about the significance of the hearings held by his committee on Watergate, Senator Ervin is reported to have said: “You can either draw a picture of a horse or you can draw the picture and put a caption under it that says ‘a horse.’ We drew a picture of a horse.” The auditor’s “subject to” qualification is analogous to the caption on the picture. Is it necessary to put a caption on the picture, or is it adequate simply to draw a clear picture?

If the financial statements adequately portray the uncertainties and their possible effect, is it really necessary for the auditor to issue a qualified opinion?

Future Shock Hits Accrual Accounting

The basic problem of portraying uncertainties in financial reporting is that financial statement amounts are traditionally presented as single values, but only a probability distribution giving a range of values can reflect reality under conditions of uncertainty. The present accounting model developed when the world was simpler and the task of accounting less complex.

Accrual accounting developed in the fifteenth century. The usual venture took about a year, the approximate time of a ship’s roundtrip voyage, and at the end of each voyage the accounts would be settled and the investors would receive their

share of profit. Accounting for a single venture such as the voyage of the ship is much simpler than reporting the continuous activity of modern business.⁷ Also, events that affect business are taking place at an increasingly rapid rate. One accountant has observed that a shoe manufacturer in 1870 would have experienced little difference in his products, customers, or techniques either twenty years earlier or twenty years later. Today, however, a shoe manufacturer is likely to run the gamut from Indian sandals to kinky boots in two to three years.⁸

Financial statements are imprecise for several reasons, but the major problem in measuring earnings is uncertainty about the future. The current concept of earnings is an *index* of success, and earnings under accrual accounting are determined by a long-range averaging process. Ideally, under accrual accounting earnings and cash ultimately will be equal in amount but there will be differences in timing.

Earning Power and Earnings Cycles

The essence of a company's earning power is its ability to generate cash in the future, but ability to generate cash is not the same as cash generated. The Trueblood Report on the objectives of financial statements explains the relationship between cash generation and earnings:

... Cash generating ability and earnings are closely related and the longer the period, the closer the relationship. For a relatively short period like a month, a quarter, or even a year, net cash flows ... will differ from earnings because of changes in such items as receivables, payables, inventories, and plant. For such relatively short periods, the accrual basis provides a more useful measure of enterprise progress than the cash basis. Over longer periods, cash generation and earnings come closer together. Over the entire life of an enterprise, they are the same.⁹

At various points in a company's life span not all transactions will be complete. Some series of related transactions extend over several annual periods. The Trueblood Report refers to these related activities as earnings cycles:

A simple earnings cycle may be identified quite easily; but for most series of transactions, it is usually quite difficult to determine when a cycle has been completed. For example, an enterprise makes a sacrifice by purchasing a plant to produce goods. In this case, the sacrifice (the cash disbursed) can be identified. But the benefit (the cash receipt) relates in some way to each unit being made, sold, and eventually realized as cash. A further benefit may arise from a cash receipt on disposal of the plant. Until the plant is sold, some of the benefits relating to the initial sacrifice for the plant will have been realized through its use in manufacturing, and some will not. Therefore, this requires estimates of the amount of the sacrifice applicable to a certain time period, whenever all benefits are not realized within that time period. Such allocations of sacrifices (or of benefits in other situations) introduce the need for additional judgments in accounting for cycles.¹⁰

Debits and Credits in an Uncertain World

Accountants have adopted various concepts and conventions to deal with the problems caused by incomplete earnings cycles. These concepts, however, attempt

to eliminate the effect of uncertainty rather than explain it.¹¹ One of these concepts is realization. Revenue is not normally recognized without some objective evidence such as an exchange transaction and the receipt of cash, or some evidence that receipt is highly probable. An attempt is made to match the sacrifices made in earning revenue against the revenue recognized in a period since the effort to earn revenue may stretch over several accounting periods. Costs incurred for future benefit are assets. A cost is not carried forward to future periods unless the amount is expected to be recovered through future operations.

Another accounting convention adopted to facilitate allocating costs among future periods is the going concern assumption. A company is assumed to have an indefinite life unless some major event, such as bankruptcy, proves the assumption wrong. This allows the allocation of costs over the useful life of an asset and avoids the problem of determining the remaining life of a company.

Another traditional accounting convention is conservatism. The operating rule for conservatism is "anticipate no gains but provide for all losses." Predicting the future is extremely difficult. Consequently, in the absence of an exchange transaction, for example, indicating that merchandise has been sold for a loss, or the occurrence of an event such as a fire that destroys a company's plant, knowing when the value of an asset has been impaired and when the loss should be recognized is also difficult.

Anticipating Future Costs and Losses

When the Pennsylvania-New York Central Transportation Company was formed by the merger of two railroads in 1968, the company charged off costs and losses of \$275 million. Penn Central's controller described that charge as "a bookkeeping loss" and stated that the company was only clearing the decks for the merger and that the substantial charge would avoid a drag on earnings for the next ten years.

Leopold A. Bernstein surveyed the reserves for future costs and losses so popular in the late 60's and early 70's and concluded that charges like the Penn Central's indicated real problems in accounting. Professor Bernstein questioned the appropriateness of reaching ten years into the future and expressed the view that reserves for future costs and losses were all too frequently income smoothing and shifting devices.¹²

The problem of when to recognize future costs and losses is important, but it is only a symptom of deeper problems in accounting for uncertainties.

The FASB Puts a Hold on the Future

Anticipating future costs and losses is an application of conservatism in accounting and independent auditors have had difficulty arguing that such anticipation is not in accordance with generally accepted accounting principles.

At one time, the applicable pronouncement was the AICPA's Accounting Research Bulletin No. 50 on contingencies, issued in October 1958. Contingencies were defined as "an existing condition, situation or set of circumstances involving a considerable degree of uncertainty which may through a related future event result in the acquisition or loss of an asset or the incurrence or avoidance of a liability." ARB No. 50 indicated that when contingencies were not sufficiently

predictable to permit recording, they should be disclosed if there was a reasonable possibility of an outcome that might affect financial position or operating results. However, when the outcome of a matter was reasonably foreseeable, the expected result should be recorded.

ARB No. 50 made the recording of a loss dependent entirely on the ability to estimate the amount, and anticipated losses due to a contingency could be recognized in a period prior to the actual incurrence of a loss. The legacy of ARB No. 50 was a paradox for independent auditors.

Under ARB No. 50 accounting principles required that if an item could be estimated, the effect should be recorded. If an estimate could not be made, the conformity of the financial statements with generally accepted accounting principles was indeterminable. The resolution was identifying the "subject to" qualification as the hallmark for the existence of an uncertainty precluding conformity with generally accepted accounting principles.

The Financial Accounting Standards Board took up the question of contingencies in 1973 because of abuses in accounting for future losses. The project was expanded to a consideration of accounting for all contingencies. In March 1975, the FASB issued Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies." It was intended to eliminate the practice of accruing for potential future losses that would not be incurred until a period after the date of the financial statements. The FASB added a requirement that a loss must relate to a current or a prior period in addition to being reasonably estimable. Thus, the requirement of reasonable estimation of ARB No. 50 is no longer sufficient to support recording.

FASB Statement No. 5 also redefines a contingency as an "... existing condition, situation, or set of circumstances involving uncertainty as to possible gain ... or loss ... to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability." Recording of a loss is, therefore, dependent on the outcome of some definable future event that may or may not occur. This definition distinguishes estimates required for contingencies from other estimates that relate to matters requiring approximation of amounts or of the timing of transactions. Also, there must be a possibility that the event may not occur. If occurrence is not uncertain, the matter is not a contingency. For example, amounts owed for services received such as advertising and utilities may need to be approximated, but there is no doubt that the service has been received.

All Contingencies Are Not Alike

Contingencies can be conveniently classified into two types. Some contingencies are a recognized part of incomplete earnings cycles. They result from normal recurring activities and the need to make estimates is known even though the amount and timing of future receipts or payments may be uncertain. Examples are estimation of the collectibility of receivables resulting from credit sales, loans, or similar transactions and recognition of obligations under warranties for products or services sold. If, based on available information, future collection or payment of such items is probable and their amounts can be estimated, the effects should be recorded and reflected in financial statements.

Other contingencies result from events that are unusual or infrequent. Since these events are not inherent in earnings cycles, identifying those that should be recorded or disclosed can be difficult. Statement No. 5 applies the same criteria to these events as is applied to estimates inherent in earnings cycles. If occurrence of a future event is probable and the amount can be estimated, the effects should be recorded. If occurrence is only reasonably possible rather than probable, the event should be disclosed.

Gulf & Western was told by an Appellate Court that its tender offer to Atlantic and Pacific Tea Company's shareholders was deficient because it failed to disclose a contingency arising from an antitrust violation. The court held:

The fact that, at the time it announced its tender offer, an antitrust action had not been commenced against G & W, and that its liability was uncertain, does not excuse G & W's failure to disclose all these relevant circumstances so that A & P shareholders could weigh them in reaching their decision whether or not to tender their shares. As we said in *SEC v. Texas Gulf Sulphur Co.*, 401 F 2d 833,849 (2d Cir. 1968) (en banc), the disclosure requirements of the securities laws require "nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative experience in reaching their own investment decisions with knowledge equal to that of the insiders." Those "basic facts" bearing upon G & W's possible liability for antitrust violations were of obvious concern to those A & P shareholders who retained part of their holdings.¹³

A possible antitrust action is one example of an unasserted claim. FASB Statement No. 5 requires that such claims be disclosed if their assertion is probable and an unfavorable outcome is reasonably possible. Unasserted claims may be known to management of a company, but they can be difficult for an auditor to identify unless the auditor is informed of the possible claims by a company's management or its legal counsel. The outcome is usually impossible for anyone to predict.

Antitrust actions frequently result in "subject to" qualifications when auditors are aware of the action. For example, the Otter Tail Power Company's auditors qualified their opinion on its 1974 financial statements and included the following description of the uncertainty in their report:

As discussed in the second paragraph of Note 7 to the Financial Statements, the Company is a defendant in suits brought by three municipalities charging antitrust violations and seeking treble and punitive damages totaling \$4,386,593. Since the ultimate outcome of the lawsuits cannot presently be determined, no provision for any liability that may result has been made in the financial statements.

In our opinion, subject to the possible effect on the financial statements of the outcome of the litigation discussed in the preceding paragraph, the above-mentioned financial statements. . . .

Other government actions resulting in possible losses may be equally difficult for the auditor and the company to identify. In 1971, for example, Abbot Laboratories' operations were interrupted by the government's recall of its U.S. produced intravenous solutions. Abbott was unable to reenter the market for intravenous solutions for four months, which had a depressing effect on its results

of operations. The beverage industry was also seriously affected when products containing cyclamates were banned. Events of this type are difficult or impossible to predict and future operations may be seriously affected when they occur.

The impossibility of predicting all events that may materially affect a company's operations has led some accountants to agree that uncertainty qualifications may result in undue expectations by investors. The absence of a "subject to" qualification may lead investors to incorrectly conclude that a company has no significant uncertainties.

Should New Guidance on Contingencies Change Auditors' Responsibilities?

FASB Statement No. 5 supplies welcome clarification of when to record and when and what to disclose concerning contingencies. Given the possible importance of such uncertainties to a company's operations, clear guidelines are beneficial to investors, auditors and the management of companies. Since Statement No. 5 has clarified this area of financial reporting, some accountants believe that "subject to" qualifications are now unnecessary.

The possible outcome of a lawsuit is perhaps the best example of a significant unusual uncertainty. Armstrong Cork Company's 1974 annual report discloses it was involved in litigation concerning patent infringement. The auditors' report and related footnote disclosure appear in Exhibit I. When such contingencies are disclosed, it is relatively easy to separate the business risk from the information risk. As long as investors are given enough information, there is no information risk. Financial statements may disclose but cannot reduce the business risk. The ultimate effect on the financial statements depends on the outcome of an identifiable future event. The type of probability evaluation involved here should be distinguished from the probability of events that are inherent in an earnings cycle. The estimation of the collectibility of receivables, for example, depends on a probability evaluation that normally involves a large number of homogeneous items. This is the classical view of probability—a concept of relative frequency which is normally applicable only to a large number of items with similar characteristics. On the other hand, a lawsuit is a unique event and the classical view of probability is not applicable. A unique event will have only one outcome—either favorable or unfavorable.

For unique events, the auditor's "subject to" qualified opinion can only emphasize a matter already spelled out for investors in financial statements. An auditor's qualification adds little and may lure investors into a false sense of security.

Since Statement No. 5 provides understandable guidance on when accounting for the future should stop, some justification exists for removing the auditor's reporting obligations for uncertainties. However, Statement No. 5 does not cover all uncertainties and the prohibition against recording certain contingencies raises other problems.

Thou Shalt Not Record

Statement No. 5 prohibits recording if the amount cannot be reasonably estimated or if the event on which the amount is contingent is not probable. The difficulties that might be caused are highlighted by a current problem of hospitals.

Malpractice suits normally involve astronomical sums and some result in

significant settlements. As a result, doctors and hospitals are having difficulty in obtaining malpractice insurance. Insurers are reluctant to offer malpractice coverage because of the difficulty of estimating future losses. That gives the hospitals both operating and accounting problems. If a hospital is unable to obtain malpractice insurance or must co-insure a large amount of the risk, an individual hospital will have even more difficulty than an insurer estimating the losses for malpractice claims.

If a hospital makes a provision for malpractice losses when the amount cannot be reasonably estimated, it will violate FASB Statement No. 5. A hospital's auditor might then include the following middle paragraph in the audit report:

As described in Note X, claims for alleged malpractice in excess of insurance coverage have been filed against the hospital by various claimants. In addition, the hospital has no assurance that additional material claims will not be asserted arising out of services provided to patients in the past. The ultimate liability of the hospital resulting from these claims is not presently determinable. Further, as discussed in Note X, the hospital has charged to income a provision for losses, relating to uninsured malpractice claims. Because of the uncertainties described above, the amount of such a provision and the related liability cannot be reasonably estimated.

Someone familiar with the requirements of FASB Statement No. 5 might conclude the auditor's opinion paragraph should object to the departure from generally accepted accounting principles—an "except for" qualification. However, some auditors can be expected to conclude a "subject to" opinion is permissible. After all, "subject to" qualified opinions are supposed to be used for uncertainties and this is an uncertainty.

When faced with similar past problems, auditors have sometimes opted for "subject to" qualifications. In the "big bath" days of the late 60's and early 70's, the special reserves for future losses complained about by Professor Bernstein also produced some interesting auditor's reports.

Allis-Chalmers Manufacturing Company, in its 1968 annual report, announced a change in management. The incoming officers adopted new policies on organization, products, production facilities, marketing, and relations with dealers and customers that resulted in recording special reserves in the last quarter of 1968 totaling \$68.7 million. For the year, the final loss was \$54 million *after recording future tax benefits of \$43 million*.

Even after that loss, the auditors were not certain enough to express an unqualified opinion and issued an opinion "subject to" two uncertainties. This is the middle paragraph of their report:

As explained in Note 3 to the financial statements, in the last quarter of 1968 the Company recorded substantial amounts associated with (a) reserves for anticipated costs and losses, and (b) estimated income tax benefits expected to be realized in the future. Although these reserves and anticipated tax benefits reflect the best current judgment of the Company's management, we cannot determine at this time the amounts of costs and losses which ultimately will be charged against the reserves, and the amounts of future tax benefits which ultimately will be realized.

The unusual aspect of this special reserve was the effect on the auditor's opinion of the related income tax effect. Allis-Chalmers obtained a refund of

only \$14 million on past taxes. That left \$50 million plus to be claimed in future years should earnings be adequate. Even though the auditors were uncertain about future tax benefits that would be realized, those tax benefits were recorded as an asset and the related gain reduced Allis-Chalmers' loss for the year.

APB Opinion No. 11 explains the generally accepted accounting principles for handling the complex differences between the taxes paid in a year and the tax expense recognized in an income statement. Opinion No. 11 provides that "... in those rare cases in which realization of the tax benefits of loss carryforwards is assured beyond any reasonable doubt, the potential benefits . . ." may be recorded.

Thus, generally accepted accounting principles require a significant degree of certainty before recognizing future tax benefits. The prohibition against recording future tax benefits is similar to the prohibition in FASB Statement No. 5. In both cases, a significant uncertainty may exist that would prevent recording. When generally accepted accounting principles prohibit recording, an auditor should object to the violation with an "except for" qualification. Nevertheless, the desirable features of a "subject to" qualification may cause auditors to focus on the uncertainty rather than on the resulting departure from generally accepted accounting principles.

In addition to the murkiness that may be caused by the uncertainties that Statement No. 5 prohibits recording are the uncertainties on which Statement No. 5 offers no guidance.

Contingencies, Commitments and Conundrums

Statement No. 5 excludes several matters that come under the heading of uncertainties in accounting.

Among the matters excluded are contingencies inseparable from other measurements inherent in earnings cycles. For example, depreciation is excluded because "the eventual expiration of the utility of the asset is not uncertain."

Another major category of accounting measurements excluded from Statement No. 5 is impairment of asset values arising from current conditions rather than depending on the outcome of future events. Some of these measurements are covered by other pronouncements: marketable securities (FASB Statement No. 12), inventory pricing (ARB No. 43), investments in common stock accounted for by the equity method (APB Opinion No. 18) and losses arising from disposal of a segment of a business (APB Opinion No. 30).

Losses on operating assets, such as plant and equipment, arising from changed current economic conditions are also excluded.

The appropriate accounting period to be charged for a loss from a contingency is also not covered by Statement No. 5. The criteria for prior period adjustments established by APB Opinion No. 9 remain unchanged.

The Silver Lining of "Subject to"

The correct period to be charged for a loss causes difficulty in accounting. There will always be differences between the estimations made and the actual results. Consequently, accountants have developed criteria for deciding whether the difference should be charged to the period when the estimate was made or to the period when the difference between the estimate and the result is determined.

If the difference is viewed as a correction of income reported in earlier periods, substantial losses or gains may escape the income statement and the attention of investors. On the other hand, reporting the differences in the current income statement may distort the measurement of a company's normal, recurring earning power.

Opinion No. 9 limits prior period adjustments to material adjustments that:

(a) can be specifically identified with and directly related to the business activities of particular prior periods, and (b) are not attributable to economic events occurring subsequent to the date of financial statements for the prior period, and (c) depend primarily upon persons other than management, and (d) were not susceptible of reasonable estimation prior to such determination.

Opinion No. 9 also observes that in most cases the opinion of the independent auditor on the financial statements of the prior period would have contained a qualification because of the uncertainty. A "subject to" qualification is not one of the criteria for determining a prior period adjustment, but there is a strong implication that the presence of a qualified opinion will make prior period treatment more justifiable. Research by Samuel Laibstain and Thomas Huff suggests that the type of auditor's opinion does have a direct relationship to the accounting period charged for subsequent adjustments. They observe that the relationship between the auditor's opinion and prior period adjustment treatment may make management more inclined to accept "subject to" qualifications:

If the auditor's opinion does govern subsequent accounting treatment of the error, another result may be that management often will readily accept a qualified opinion if it suspects that actual results may be significantly worse than its estimate, reasoning that subsequent adjustment will be to retained earnings.¹⁴

Indeed, in its 1974 annual report the management and independent auditors of Del E. Webb Corporation complain bitterly about the denial of prior period adjustment treatment. The middle paragraph of the auditor's report explains the matter as follows:

Our previously issued accountants' report dated February 28, 1974 on the 1973 consolidated financial statements was qualified subject to the effect of the resolution of the claim against the Government of Honduras. Included in the accompanying consolidated statement of earnings for the year ended December 31, 1974 is a charge of \$2,749,444, representing the write-offs of amounts recorded in connection with this claim (as more fully explained in note 2 to the consolidated financial statements), which the management of Del E. Webb Corporation believes should have been recorded as a prior period adjustment. It is our opinion that it would have been preferable to accord this charge prior period adjustment treatment, which would have increased 1974 net earnings by \$1,474,549 (\$.17 per share).

Note 2 to the financial statements explains that the SEC insisted that the \$2.7 million charge appear in the 1974 results of operations.

This SEC action does not seem to be an isolated example. In fact, the SEC staff seems to have embarked on a campaign to eliminate prior period adjustments and the FASB is also reported to be working on the subject. If prior period

adjustments become a thing of the past, “subject to” qualifications will make even less sense.

The auditor’s qualification could be viewed as pointing out to investors that the financial statements being reported on might be adjusted at some future date when the uncertainty is resolved. Some accountants have suggested “subject to” qualifications should be used only when the financial statements might be adjusted. If any gain or loss would be shown in the financial statements of a future period, the financial statements reported on would never be changed. Henry Hill states the case:

Auditors should take care that they let the financial statements speak for themselves. When uncertainties arise, a careful analysis should be made to see whether unfavorable resolution will have an effect on the current financial statements. “Subject to” opinions should be limited to events that will have such an effect. Other contingencies should be clearly recited in the financial statements in the interest of full disclosure, but this does not mean they are a proper component of the auditor’s report. In other words, as far as uncertainties are concerned, the factors that lead to retroactive restatement should be precisely the same as the factors leading to a “subject to” opinion.¹⁵

The fact that either favorable or unfavorable resolution of uncertainties with respect to an earlier year’s financial statements may cause no adjustment of those statements violates intuitive logic, but as Mr. Hill observes.

Logic may not always prevail . . . where debits and credits are involved, for such a solution invites debits to the rear, credits to the fore. The policing instinct of auditors makes them shrink from encouraging practices which permit omission of recording of losses from the current year’s financial statements. . . . One way to resolve the problem would be to do away completely with “subject to” opinions where estimates are involved. This would not further the interests of the financial statement reader, however, and it would deny the auditor some protection.¹⁵

Prediction, Protection and Professionalism

Two critical questions are whether the interests of financial statement readers are furthered by “subject to” qualifications and whether the independent auditor receives any protection from them.

A “subject to” qualification does post a warning to investors that financial statements reported on by the auditor may need to be changed. However, many uncertainties when resolved will not result in retroactive restatement of financial statements and the number of uncertainties that will receive prior period adjustment treatment grows smaller every day. Another reason for posting a warning might be implementation of a new idea being pushed by the SEC staff that disclosure is required whenever historical operating results may not be indicative of future results because of some matter within management’s knowledge.¹⁶

At this date, however, generally accepted accounting principles and the rules of the SEC do not require such disclosures in financial statements. The only place that the SEC requires such disclosure is in management’s discussion and analysis of the summary of operations which is not part of the financial state-

ments. Even if the necessity of disclosing such matters in the financial statements were acknowledged, there is no compelling reason to believe that adequate disclosure would not sufficiently warn investors.

The essential question then becomes whether investors need or want a prediction of future events or whether they would be better served by information that would allow them to make their own assessments of whether the risk inherent in the company's activities is one they will accept. Contingencies by definition depend on the outcome of future events. Contingencies involving infrequent or unusual future events are not susceptible to normal estimation methods. The Trueblood Report recognizes distinctions are necessary among different kinds of measures that vary in the certainty of their ultimate impact on cash. The view taken of earnings measurement in the Trueblood Report assumes "... users generally will want to make their own judgments about uncertainty."¹⁷

Contingencies involving infrequent or unusual future events should be fully disclosed. Investors should be given enough information to make their own assessment of risk. This conclusion does not fully resolve the auditor's responsibility because other uncertainties may also cause a "subject to" qualification.

Are Asset Evaluations Uncertainties?

The carrying amount of an operating asset may exceed the amount expected to be recovered through future use of the asset because of current conditions that make recovery of the carrying amount doubtful. For example, the Callahan Mining Corporation at the end of 1974 did not know whether one of its mines could be operated because of geological risks involved in deep shaft exploration. The auditor's qualified opinion and the related note to management's financial statements appear in Exhibit II.

Operating assets are used over many accounting periods and a company may not intend to dispose of the assets in the near future. Even though the estimation of the appropriate carrying amount of the asset depends on current conditions, the accuracy of that estimate cannot be determined with certainty unless the asset is sold or abandoned. Also, if the asset is disposed of at a loss at a future date, the loss may have arisen in subsequent periods. Thus, the amount realized may not indicate the appropriate carrying amount at an earlier date.¹⁸

Another problem in determining the appropriate carrying amount of an asset is that most assets are used jointly to generate future receipts of cash. The contribution of an individual asset to the earnings process cannot be determined uniquely when it makes a joint contribution.

The contribution that the auditor can make has some limitations because of the number of factors involved in determining the appropriate carrying amount of an asset. The auditor can determine that the asset exists and that it is owned by the company, but the uncertainty surrounding the future cash receipts that will result from using the asset makes evaluation of the appropriate carrying amount difficult.

Auditors' opinions are qualified "subject to" the company's ability to recover the carrying amount of assets. Whether disclosure of those uncertainties would be sufficient without qualification is a critical question. Statement No. 5 offers no guidance.

The SEC Fills the Disclosure Gap

In late 1974 the SEC issued Accounting Series Release No. 166 on the disclosure of unusual risks and uncertainties in financial reporting. ASR No. 166 recognizes that additional disclosures may be necessary when:

- Special circumstances affect a company's ability to measure current results.
- Current economic conditions have changed the risk characteristics of assets.
- Assumptions underlying the use of certain accounting principles have become subject to substantial uncertainty.

All of the examples in ASR No. 166 relate to the carrying amount of assets such as loan loss reserves for financial institutions, marketable securities, and the operating assets of some companies with a small number of projects that have a dominant effect on operating results. Examples of projects with a dominant effect include major aircraft by aircraft manufacturers and construction contracts by contractors.

The following recommendation in ASR No. 166 seems to be the prototype:

The disclosure should include a description of the unusual circumstances involved, a description of the types of assumptions made by management when preparing financial reports, and an indication of the sensitivity of current and prospective earnings to changes in such assumptions caused either by changing circumstances or the final determination of the uncertainties involved.

The thrust of the ASR seems to be to put disclosure of uncertainties concerning the carrying amount of assets on the same basis as contingencies. The disclosure recommendations highlight uncertainties and describe the sensitivity of operating results to estimates. The notes, in effect, suggest the probability distribution behind the single amount in the financial statements.

When Is Disclosure Not Enough?

The recent decisions, one by the Federal District Court for the Southern District of New York and the other by the SEC in an administrative proceeding illustrate that a "subject to" opinion will be of little value to an investor, or to an auditor defending an action, if the extent of the disclosure about the uncertainty causing the qualification is inadequate. The administrative proceeding involved an audit of Talley Industries, Inc. (Talley) by Peat, Marwick, Mitchell & Co. (PMM).

Talley was engaged in the manufacture and distribution of various products, including bomb racks and pyrotechnics designed for the U.S. Armed Forces. In connection with a proxy statement being distributed to solicit approval of the merger of Talley with another company, PMM issued a qualified opinion on Talley's financial statements for the year ended March 31, 1969. The opinion was qualified "subject to" Talley's ability to obtain sufficient future contracts as referred to in Note 3 to the financial statements. Note 3 stated:

The Company bases its calculation of inventories and of cost of sales ap-

plicable to fixed price United States Government contracts on the costs (including administrative overhead) incurred and estimated to be incurred on the relative production programs. For the purpose of computing sales, these costs are prorated over the estimated total revenues for such programs. The estimates are based on actual contracts on hand and future contracts expected by management to be obtained. The resultant value of inventories on this basis at March 31, 1969, is approximately \$8,900,000 in excess of the prorated cost of actual contracts on hand and such excess is believed to be larger at December 31, 1969, but management expects sufficient future contracts to be received to recover such excess.

The SEC found the opinion and related footnote to be materially deficient in the following respects:

- The note did not disclose the dollar amount of future contracts (\$100 million) which Talley's management estimated would be obtained.
- Since recovery of excess costs was dependent in part on Talley's achieving projections of material savings in production costs, the report should also have been qualified with respect to Talley's ability to perform contracts in a profitable manner.

The PMM proceeding does not have the authority of case law, and PMM for purposes of the settlement order neither admitted nor denied any of the statements or conclusions of the SEC, but the position taken by the SEC on qualified opinions is instructive. The lesson is that the SEC will look beyond the words of qualification to determine whether adequate disclosure has been made in the auditor's report, the financial statements, or in the related footnotes, of the uncertainty causing the qualification.

The SEC's analysis of the Talley case emphasized the difficulty and subjectivity of the prediction. In projecting future sales, Talley had to predict the total dollar amount of future contracts for a particular product to be awarded by defense agencies and the portion of the total market for that product they would be successful in capturing. Underlying the SEC's criticism seems to be the belief that the projection of \$100 million in sales when Talley had a backlog of orders of only \$24 million required something more than a "subject to" qualification. The SEC stated:

... we believe that the auditors relied too heavily upon the representations, projections and estimates made by Talley's management and did not require sufficient documentation and evidential matter to enable them to review adequately the sales projections and cost estimates for reasonableness.

In such circumstances, disclosure may not be enough.

Everything You Ever Wanted to Know About an Uncertainty and More

The other case implies that disclosure may sometimes be enough, but that a "subject to" qualification is a poor substitute. In *Herzfeld v. Lavenethol, Krekstein, Horwath & Horwath*,²⁰ the critical transaction involved the purchase by The Firestone Group, Ltd. (FGL) of certain nursing homes on November 22, 1969 for \$13 million and their subsequent sale four days later for \$15 million to a company run by a Mr. Ruderian. Both the purchase contract and the sales contract

provided for a payment of \$5,000 on execution of the contract, \$25,000 approximately one month later, a payment of \$4 million (on FGL's purchase) or \$5 million (on FGL's sale) on January 30, 1970, with remaining amounts to be paid over a period of 25 years in monthly installments. The auditor's opinion on FGL's financial statements was qualified "subject to the collectibility of the balance receivable on the contract of sale (see Note 4 to the Notes to Financial Statements)." Note 4 set forth the basic terms of the contracts of purchase and sale and stated that of the total profit of approximately \$2 million only \$235,000 was included in income, with the remainder deferred until payment was made on January 30, 1970.

The sale of the properties by FGL was never accomplished as FGL went bankrupt, and certain investors in FGL brought suit against the auditors, alleging that the financial statements did not disclose material facts known by the auditors concerning the purchase and sale contracts. The auditors argued that their qualification and the disclosures in the note to the financial statements adequately alerted potential investors to doubts the auditors had about the collectibility of this significant account receivable.

The court rejected the auditor's argument, stating that:

We agree that the qualification throws some doubt on whether the transaction would be culminated, but we think more was required of Laventhol as an independent auditor. Each investor was entitled to decide for *himself*, on the basis of the stark facts, whether the transaction had a realistic prospect of being completed. The information needed to make that judgment and known to Laventhol was not disclosed in the Laventhol report. (Emphasis in original)

The court stated that the auditors should have disclosed such facts as that the party buying the properties had a net worth of only \$100,000, and that the president and controlling stockholder of the buyer, Mr. Ruderian, was not personally liable on the sales contract.

The full litany of the disclosures suggested by the court follows:

Thus, we believe that the full disclosure mandated by the Act required Laventhol to include in its report *at least* the following facts: (1) Continental's net worth; (2) the ambiguity of the language in the contracts which might have suggested to some that they were options; (3) Ruderian, on whose reputation and representations Laventhol was depending, was not personally liable on the contracts; (4) Ruderian's practice of reselling property before he paid for it; (5) neither of the transactions was recorded in FGL's books of original entry or corporate minute books; (6) this transaction was the largest in which FGL had ever participated; (7) FGL would show a loss if the income from the Monterey transactions were not realized; (8) FGL had not acquired title to the nursing home properties from Monterey; (9) no deed, title search or title insurance on the properties had ever been obtained by FGL; and (10) the legal opinion sought by Laventhol, on which it relied in treating the transaction as an enforceable purchase and sale, had been obtained over the telephone from an attorney who not only never saw the contract but never even had it read to him on the telephone.

The court seems to have emphasized the need for adequate disclosure by

throwing in everything that might possibly be disclosed. The decision is presently being appealed and the disclosure burden imposed has been criticized. However, the court's message is clear. The important thing is the adequacy of disclosure and providing the investor with enough information to make a personal assessment of the possible outcome of the uncertainty. The auditor's "subject to" qualification alone does not do that. The inescapable question is: If the financial statements contain enough disclosure to allow the investor to make appropriate assessment, is there any need for the "subject to" qualification?

Many accountants are coming to the conclusion that the "subject to" qualification serves little purpose for most uncertainties. The financial statements can and should give a clear picture of the company's status and prospects along with a description of the uncertainties that make an accurate picture impossible. However, these accountants would like to hang on to the "subject to" qualification for the ultimate uncertainty of all—doubt about the company's ability to continue in operation.

The Going-Going-Gone Concern

This point brings us back to where the analysis started with W. T. Grant. A company's ability to continue to operate as a going concern is one of the most fundamental uncertainties faced in the preparation of financial statements. When such doubts exist, auditors have expressed "subject to" qualifications or in severe cases disclaimed an opinion.

The qualification of an opinion because of doubts about a company's going concern status has a number of drawbacks. First, there are no accepted criteria for determining when a company has changed from a going concern to a gone concern. Even the fact that a company has filed for bankruptcy is not conclusive evidence that it will be forced to liquidate. Second, if the decision is made that financial statements should be prepared using liquidating values rather than amounts that would be appropriate for a continuing company, there are no generally accepted accounting principles to explain how those financial statements should be presented.

Research indicates that analysis of financial statements is probably a better method of evaluating a company's future prospects than relying on a qualified opinion. Edward Altman and Thomas McGough prepared a quantitative model based on ratios of financial statement amounts. Generally, their bankruptcy model proved to be the better predictor of company failure. Altman and McGough explained the relationship between their model and the auditor's report as follows:

The bankruptcy model and the auditors' report have different but analogous functions. The model was developed to predict bankruptcy. The auditor does not attempt any such prediction. An unqualified opinion is not a guarantee that a company will continue as a going concern, but an exception because of going-concern problems is not a prediction of liquidation. An opinion expressing doubts concerning a company's ability to continue as a going concern is based on the uncertainty of the fairness of presentation of the financial statements. It would be possible for financial statements based upon historical cost to be fairly presented when the company is facing bankruptcy if the carrying value of the assets of that company represents the realizable value of those assets.²¹

Thus, the effect of the going concern question on the auditor's report is not significantly different from the concern with the impairment of asset values based on an evaluation of current economic conditions. It is doubtful that the going concern assumption adds anything to the concept of realization. The auditor's concern with asset realization and the amount and classification of liabilities would be the same without any going-concern assumption because of the realization concept.

Another drawback is that the auditor's qualification is a "self-fulfilling prophecy." A company's financial and operating difficulties should be apparent from its financial statements. A "subject to" qualification only adds to a company's problems and may hasten its demise. Accounting Series Release No. 115 adds a new dimension because it puts the auditor in the position of deciding whether a company is able to obtain more funds to continue operations. The SEC will not accept a "subject to" qualification based on a company's going concern status in a registration statement. Thus, a company unable to continue operations unless it obtains more funds cannot obtain those funds by a public offering of securities.²²

The auditor's present responsibilities for reporting on uncertainties may force him to predict future events and analyze the company's future prospects. These may be useful functions, but the question is whether they are compatible with the auditor's role and whether an auditor is competent to effectively perform them.

What Is the Auditor's Role?

The auditor's role is to add to the credibility of financial information. Information risk and business risk should not be confused. Financial information should portray the risks under which a company operates. Predicting the outcome of future events and hence attempting to eliminate those risks from financial statements is incompatible with the auditor's basic role.

If disclosure in the financial statements is adequate and the auditor's "subject to" qualification adds nothing, the availability of that qualification may cause the auditor to stop short of insisting on all the disclosures necessary to inform investors and place them in a position to evaluate the outcome of uncertainties. Further, the fact that auditors do issue "subject to" qualifications may lead investors to think that the absence of a "subject to" qualification means that the company has no significant uncertainties. In other words, investors may be led to rely on the auditor to evaluate business risk when the essence of investing is evaluating business risk and taking a chance on the outcome. Auditors should not accept a responsibility that would tend to shift some portion of business risk to them. Their function is to minimize the information risk. The auditor's attention should be freed for an evaluation of the adequacy of disclosure concerning uncertainties.

Under present requirements, some matters closer to departures from generally accepted accounting principles that cannot be evaluated by investors receive "subject to" qualifications because they contain an element of uncertainty. A distinction is called for between contingencies involving unusual or infrequent events that depend on an unpredictable future outcome and questions concerning the impairment of asset values based on current economic conditions. Disclosure is probably adequate to inform investors about such contingencies. For other

matters presently called uncertainties, auditors must evaluate the adequacy of disclosure and consider whether the failure to recognize a loss or recognizing an uncertain profit is in reality a departure from generally accepted accounting principles. A departure will exist whenever generally accepted accounting principles require a reasonable estimate that does not depend for its resolution on the outcome of a future event. If the auditor does not believe disclosures of the type recommended by ASR No. 166 adequately portray the business risk, a "subject to" qualification is inadequate.

Thus, I recommend that the requirement to issue a "subject to" qualification be eliminated. It is not an appropriate responsibility for auditors. However, the term "uncertainties" has been used too broadly, and careful distinctions must be drawn between contingencies for which no qualification is required and other matters that under my recommendation may be either departures from generally accepted accounting principles or matters of insufficient evidential matter requiring the auditor to issue a qualified opinion or disclaim an opinion because of a restricted examination.

Future Accounting for the Future

As generally accepted accounting principles are developed, much more will have to be done to make investors aware of the uncertainties involved in the preparation of financial statements.

The Trueblood Report contains recommendations that would improve the ability of investors to identify and evaluate uncertainties.²³ For example, it recommends that ". . . basic underlying assumptions with respect to matters subject to interpretation, evaluation, prediction or estimation should be disclosed." It also contains a number of other ideas that would improve disclosure and presentation of uncertainties. For example:

- Classify assets and liabilities by uncertainty of amount and timing of cash flows rather than on the basis of liquidity.
- Separate operations into complete and incomplete earnings cycles and disclose the results of those cycles separately.
- Disclose ranges of precision, reliability, and uncertainty rather than single valued estimates.

Implementation of the recommendations of the Trueblood Report may be a long way off and until the new ideas about providing information concerning the effect of uncertainty on the financial statements can be implemented, some intermediate measures would be worthwhile.

First, the type of disclosure recommended by the SEC in ASR No. 166 could be implemented on a more wide-scale basis. The sensitivity of operating results to the matters affected by significant uncertainties should be routinely disclosed.

Another possibility would be to expand the note on disclosure of significant accounting policies to better explain the assumptions and estimates involved in certain accounting methods. The percentage of completion method for recognizing revenues would be an outstanding candidate for elaboration.

Significant uncertainties are important enough to deserve their own financial statement note, similar to the note on significant accounting policies. Thus, in-

vestors would have one place to look for a description of significant uncertainties instead of being required to read long notes on litigation to pick out an antitrust suit that could put the company out of business. Investors would not need to probe credit agreements to find that one recent agreement has locked up the company's ability to pay dividends, dispose of assets, or enter into any new debt arrangements.

The auditor's role in evaluating these disclosures would be difficult. In many ways it may be more difficult than the present responsibilities for reporting on uncertainties. However, the auditor's task is to evaluate whether or not the company's financial picture adequately portrays the business risk and not to reduce or assume that risk. An auditor should decide whether the picture is clear enough, rather than worry about whether a caption is necessary to let people know what a poor picture represents.

Footnotes

1. My first exposure to this concept was in "An Examination and Clarification of the Role for Auditing in the Production and Dissemination of Capital Market Information" by Robert E. Hamilton; a dissertation presented to the Faculty of the Graduate School of Business Administration, University of Southern California, May 1975.

2. Henry P. Hill, "Reporting on Uncertainties by Independent Auditors," *The Journal of Accountancy*, January 1973, pp. 55-60.

3. Louis H. Rappaport, *SEC Accounting Practice and Procedure*, Third Edition, The Ronald Press Company, New York, 1972, pp. 2520-2521. (The same comment appeared in the First Edition in 1956.)

4. Carman G. Blough, "SEC Release on Opinions and Opening Inventories," *The Journal of Accountancy*, May 1962, pp. 71-73.

5. "All Numbers are not Equal," *Forbes*, July 1, 1973, pp. 33-35.

6. *Ibid.*

7. The effect of the pace of current events on accrual accounting is from James J. Powers, "Future Shock Jars Accounting World," *The New York Times*, June 2, 1974.

8. This illustration and some excellent observations on the auditor's role are found in A. M. C. Morison, "The Role of the Reporting Accountant Today," *Accountancy*, January 1971 and March 1971.

9. Study Group on the Objectives of Financial Statements, *Objectives of Financial Statements*, AICPA, October 1973, p. 23.

10. *Ibid.*, p. 29.

11. Discussion of accounting concepts and conventions designed to reduce the effect of uncertainties on financial statements is from John Dewhirst, "Dealing with Uncertainty," *Canadian Chartered Accountant*, August 1971, pp. 139-140.

12. Leopold A. Bernstein, "Reserves for Future Costs and Losses—Threat to the Integrity of the Income Statement," *The New York Certified Public Accountant*, July 1970, pp. 541-546.

13. In *Gulf & Western Ind. Inc. v. Great Atlantic & Pacific Tea Co., Inc.*, 476 F.2d 687, 697 (2d Cir. 1973), CCH Fed. Sec. L. Rptr. ¶ 93,814.

14. Samuel Laibstain and Thomas Huff, "The Financial Reporting of Revised Loss Estimates," *Financial Analysts Journal*, May-June 1971, pp. 62-69.

15. Hill, *loc. cit.*

16. The SEC's requirements are explained in Accounting Series Release No. 159, August 14, 1974 on Amendments to Guide 22 and Guide 1.

17. Study Group on the Objectives of Financial Statements, *Op. Cit.*, p. 33.

18. The factors that cause random variation in the difference between estimates about assets and actual results are further explained in William R. Scott, "A Bayesian Approach to Asset Valuation and Audit Size," *Journal of Accounting Research*, Autumn, 1973, pp. 304-330.

19. This case is discussed in Accounting Series Release No. 173, "In the Matter of Peat, Marwick, Mitchell & Co.," Washington, D.C.: SEC, July 2, 1975.

20. U.S.D.C., S.D.N.Y. No. 71 Civ. 2209 (LFM), May 29, 1974, CCH Fed. Sec. L. Rptr. ¶ 94,574.

21. Edward I. Altman and Thomas P. McGough, "Evaluation of a Company as a Going Concern," *The Journal of Accountancy*, December 1974, pp. 50-57.

22. The Release and the burden it places on the auditor to decide whether a company can go public are explained in Lloyd E. Shefsky and Edward J. Schwartz, "Disclosures and Re-

porting under SEC's ASR No. 115," *The Journal of Accountancy*, September 1973, pp. 53-61.

23. The discussion related to improving the communication of uncertainties in financial reporting is found in Chapter 5, particularly pp. 34-40.

Exhibit I

Example of Auditor's Report and Related Note on Outcome of Lawsuit Against the Company

ARMSTRONG CORK COMPANY

Auditor's Opinion

The Board of Directors and Stockholders,
Armstrong Cork Company:

We have examined the consolidated balance sheets of Armstrong Cork Company and subsidiaries as of December 31, 1974 and 1973 and the related consolidated statements of earnings and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The company is involved in continuing litigation relating to patent infringement. The amount of damages, if any, resulting from this litigation cannot be determined at this time. See Litigation on this page for further details.

In our opinion, subject to the effect on the accompanying financial statements, if any, of the resolution of the matter referred to in the preceding paragraph, the aforementioned consolidated financial statements present fairly the financial position of Armstrong Cork Company and subsidiaries at December 31, 1974 and 1973 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles which, except for the changes in 1974, with which we concur, in the method of valuing inventories and the method of accounting for fluctuations in foreign exchange rates explained on pages 19 and 20 of the financial review, have been applied on a consistent basis.

Notes to Financial Statements

In February, 1975, the Court of Appeals for the Third Circuit affirmed the earlier decision of the United States District Court holding that the company infringed chemical embossing patents held by Congoleum Industries, Inc. The decision applies only to the company's United States manufacture of a certain type of rotovinyl flooring during the period 1967 through 1972. A request for the review of this decision by the Supreme Court of the United States is now being actively pursued.

In 1973 the disputed chemical embossing process used by the company was modified to avoid further claims of infringement. The trial to determine if the modified chemical process infringes the Congoleum patents has been held, and a decision should be forthcoming in 1975.

By January 1, 1975, the company had replaced the chemical embossing technique with a mechanical embossing process involving no question of patent infringement. Accordingly, any injunction issued will not prevent the continued production of rotovinyl flooring by the company.

Suits also are pending in the United Kingdom and Canada involving comparable chemical embossing patents. Neither of these suits has reached the trial stage.

The amount of potential damages, if any, will not be known until all legal procedures have been exhausted. However, with the sales of the disputed rotovinyl material constituting a relatively small share of consolidated sales, it is management's opinion that the potential liability could have no material adverse effect on the business or financial position of the company.

Exhibit II

Example of Auditor's Report and Related Note on Recoverability of Asset Book Value

CALLAHAN MINING CORPORATION

Auditors' Opinion

To the Board of Directors and Shareholders of
Callahan Mining Corporation

We have examined the consolidated balance sheet of Callahan Mining Corporation and Subsidiaries as of December 31, 1974 and the related statements of income and retained earnings

and of changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We previously examined and reported upon the financial statements for the year 1973.

The Company's investment in the Caladay Project is carried at cost, the recovery of which is subject to the success of the project which cannot be forecast at this time, as described in Note 2 to the consolidated financial statements.

In our opinion, subject to the effects on the financial statements of the ultimate realization of the carrying value of the investment in the Caladay Project, the aforementioned consolidated statements present fairly the financial position of Callahan Mining Corporation and Subsidiaries at December 31, 1974 and 1973 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Notes to Financial Statements

2. At December 31, 1974, the Company's investment in the Caladay Project aggregated \$3,265,000, including \$247,000 representing the cost of property contributed by Callahan and \$980,000 representing the net book value of buildings and equipment. The recovery of this investment is subject to the success of the project which cannot be forecast at this time. See page 4.

(Page 4)

Caladay Project

The Caladay Project, which adjoins the Galena mine on the east, remained on a care and maintenance basis during 1974. Escalating costs have made reactivation of the proposed deep shaft exploration program unattractive at present in light of the geologic risks involved. Discussions continue on a less costly alternative approach under which initial exploration of this property may be carried out from one or more of the lower levels of the Galena mine.

In the interest of increased public awareness of mining activities in the District and elsewhere, the Caladay tunnel and underground workings were made available during Expo 74 for underground tours by some 15,000 visitors to the area.